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28962—37

In the Supreme Court of the United States

OCTOBER TERM, 1937

No. —

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

MOUNTAIN PRODUCERS CORPORATION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Tenth Circuit entered in this cause on August 26, 1937.

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 41–58) is reported in 34 B. T. A. 409. The opinion of the Circuit Court of Appeals (R. 199) is reported in 92 F. (2d) 78.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered August 26, 1937 (R. 208). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1935.

QUESTIONS PRESENTED

1. Is income which the respondent's affiliate received under a trust agreement with the owner of an oil and gas lease from the State of Wyoming exempt from Federal income tax?

2. The purchaser of all of the oil produced from the oil lands of the respondent's affiliate agreed to pay and paid all production and development expenses in addition to the cash price paid for the oil. Are the purchaser's expenses part of the gross income of the affiliate for purposes of percentage depletion?

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 14–16.

STATEMENT

During the calendar year 1925, the tax year in question, the respondent, a Delaware corporation, owned all of the capital stock of, and was thus affiliated with, Wyoming Associated Oil Corporation, a Delaware corporation, hereinafter called Wyoming Associated. The respondent filed a consolidated income tax return for that year upon

which the deficiency involved in this case was determined (R. 42, 69).

Wyoming Associated, immediately after its organization in 1919, obtained deeds, assignments, and conveyances covering certain placer mining claims, patented lands, and interests in oil and gas leases in the Salt Creek Oil Field in Natrona County, Wyoming (R. 42, 70–75). Pursuant to the Oil and Gas Leasing Act of Congress approved on February 25, 1920, Wyoming Associated in 1920 and 1921 exchanged its placer mining claims for Government leases (R. 43, 76) and on or about February 1, 1923, exchanged certain lands and leases for similar property of Midwest Oil Company and Wyoming Oil Fields Company in the Salt Creek Oil Field for the purpose of consolidating leaseholds into more compact blocks to decrease offset drilling (R. 43, 76).

On February 1, 1923, Wyoming Associated and the Midwest Oil Company executed a "Declaration of Trust" which recited that the Midwest Oil Company, owner of a five year lease from the State of Wyoming dated October 1, 1919, and covering all of one section of school land in Natrona County granted to the State by the United States, held an undivided fifty per cent. interest in the lease and in the renewals and extensions thereof and in the benefits and net proceeds to be realized therefrom, for the use and benefit of Wyoming Associated, which agreed to share the obligations of the lease

(R. 43, 146–147). The five year lease here involved from the State of Wyoming to the Midwest Oil Company, dated April 19, 1923, and to begin October 1, 1924, on expiration of the former lease, also covered all of the said section of school land (R. 46–47, 163–170). This lease stated that it was agreed that no assignment should be made without the consent of the State of Wyoming (R. 47, 169). The record does not disclose any assignment of the lease either with or without such consent (R. 55).

The State received its agreed royalty of sixty-five per cent. of the oil produced in kind and the proceeds of the sale of the remaining oil were divided equally between Wyoming Associated and the Midwest Oil Company in 1925 (R. 46).

On the same date, February 1, 1923, Wyoming Associated, Midwest Oil Company, and Wyoming Oil Fields Company entered into a contract (R. 147–154) with the Midwest Refining Company which referred to the declaration of trust and provided that the Midwest Refining Company agreed to buy and the other three companies agreed to sell, until January 1, 1934, all the oil produced from the property in the Salt Creek Oil Field owned or leased jointly by them (except oil used for drilling, domestic or production purposes) upon a sliding scale of prices based on the average price received by the Refining Company for gasoline and kerosene (R. 44, 148–149). The three companies agreed to give the Refining Company free use of all equip-

ment on the property and of all oil and gas reasonably necessary for production operations (R. 44, 150). The Refining Company agreed "as part of the price for oil purchased" to conduct all development and production operations upon the said lands (R. 45, 150–151). The Refining Company agreed to take delivery of the oil purchased at the outlet gates of the measuring tanks located at or near the wells on the property and also agreed that the oil royalties in kind to which some of the tracts of land were subjected were not included in the purchase agreement and would be delivered by the Refining Company to the royalty owners (R. 45–46, 151).[1]

The consolidated return for 1925 filed by the respondent and its affiliate, Wyoming Associated, was on the accrual basis and did not include the income received from the state school land under the declaration of trust of the Midwest Oil Company (R. 42) and did not include as income any amount expended by Midwest Refining Company under the two production contracts dated February 1, 1923. These expenses were not entered on the books of the respondent or of Wyoming Associated as income. The return included in gross income the net prices actually received under the produc-

[1] A separate contract containing similar provisions for the oil lands in the Salt Creek Field owned or leased solely by Wyoming Associated was entered into between Wyoming Associated and the Midwest Refining Company for the same period of time (R. 46, 155–163).

tion contracts. The return computed depletion based on gross income by taking 27½% of the market price of oil in the field at the date of production (R. 48). The tax of $271,342.32 disclosed by the return was paid in five installments in 1926 (R. 48).

In a letter dated March 14, 1929, the Commissioner notified the respondent of a deficiency of $90,642.87 determined for the most part by including in income the amount of $185,438.83 received under the declaration of trust of the Midwest Oil Company, and by reducing the depletion allowance to a percentage of the cash received for oil produced (R. 10–11, 42).

Before the Board of Tax Appeals the respondent urged that the income received under the declaration of trust was immune from tax and that the gross income on which the percentage depletion should be computed with respect to the other oil properties should be (1) either the market value of the oil produced, or (2) the amount of $4,606,535.70 received under the contracts for oil purchased plus the operating expenses of the Midwest Refining Company in the amount of $2,816,520.04 (R. 28, 42, 189). It also urged that in lieu of percentage depletion the Commissioner should have allowed depletion based upon cost (R. 23, 42).

The Board of Tax Appeals held that (1) gross income of Wyoming Associated for purposes of computing depletion did not include expenses of

the Midwest Refining Company; (2) income under the trust agreement from the state school land is not exempt from Federal income taxation; and (3) depletion based on gross income, excluding expenses of Midwest Refining Company, or on cost, whichever was greater, should be recomputed (R. 49–58). Thereupon the deficiency was reduced to $67,509.13, apparently for the reason that cost depletion of some leases exceeded percentage depletion (R. 58–59).

The Circuit Court of Appeals reversed the Board on both issues and held that respondent's gross income for calculation of depletion included the operating expenses of Midwest Refining Company and that the income from the school land lease was exempt. Circuit Judge Phillips dissented with an opinion on the second issue (R. 205).

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In holding that the income received by Wyoming Associated under the trust agreement with the Midwest Oil Company from the lease of state school lands is exempt from Federal income taxes.

2. In holding that gross income of Wyoming Associated for the computation of percentage depletion should include not only the cash received for oil sold but also the expenses of the purchaser incurred in the production of the oil pursuant to the purchase agreements.

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REASONS FOR GRANTING THE WRIT

1. In holding that the income received by the respondent's subsidiary, Wyoming Associated, under the trust agreement with the lessee of the state school lands, was immune from Federal taxation, the Circuit Court of Appeals, we believe, misapplied and improperly extended *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393, to this case in which the subsidiary was not the lessee of the state lands and had direct contractual relations only with the private lessee of the state lands. In *Burnet* v. *Coronado Oil & Gas Co., supra,* this Court held that the income of a *lessee* from a lease of school lands from the State of Oklahoma was exempt from Federal income taxes, but stated at page 398 that this Court was disposed to apply the doctrine of *Gillespie* v. *Oklahoma,* 257 U. S. 501, there involved, "strictly and only in circumstances closely analogous to those which it disclosed." Cf. *Burnet* v. *A. T. Jergins Trust,* 288 U. S. 508, 516. In the instant case, as pointed out in the dissenting opinion of Judge Phillips, neither the respondent nor its affiliate, Wyoming Associated, dealt directly with the State of Wyoming but dealt solely with the State's lessee, Midwest Oil Company.

The decision of the court below is in substantial conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in *Bankline Oil Co.* v. *Commissioner,* 90 F. (2d) 899, in which the taxpayer's petition for certiorari was granted October

25, 1937, No. 388, October Term, 1937, and was not opposed by the Government because of the conflict with the present case. In the *Bankline* case the Circuit Court of Appeals held that income of the assignee of an oil lease of tide lands from the State of California was not exempt from Federal income taxation, and followed *Burnet* v. *A. T. Jergins Trust, supra.* We do not believe that the fact that the State of Wyoming in the present case received the lands from the United States in trust for purposes of a public school system and that California in the *Bankline* case held the tide lands there involved as sovereign on an implied trust for the people of the State presents a controlling distinction.

In addition to the *Bankline* case other decisions have refused to extend the rule of immunity of the *Coronado* case to income derived by an assignee of such a lease from sublessees, *Wanless Iron Co.* v. *Commissioner,* 75 F. (2d) 779 (C. C. A. 8th); to income from sale of such leases, *Marland* v. *United States,* 53 F. (2d) 909 (C. Cl.) or to income from rent of buildings on the leased lands, *Metropolitan Bldg. Co.* v. *United States,* 12 F. Supp. 537 (C. Cl.).

2. The decision of the court below that gross income of the respondent's affiliate for computation of percentage depletion includes, in addition to the cash contract purchase price of $4,606,535.70 received for the oil sold, also the sum of $2,816,520.04 expended under the contract by the purchaser to

produce the oil, conflicts in principle with *Signal Gasoline Corp.* v. *Commissioner,* 66 F. (2d) 886 (C. C. A. 9th). In the *Signal* case the court held that the purchaser of wet gas, under a contract for which a very valuable consideration was paid and in which the purchaser agreed to assist and thereafter did assist in production of wet gas by installation and operation of machinery for that purpose at great expense, did have a right to share in the wet gas produced and, consequently, a depletable interest which might be proved. On a second appeal, 77 F. (2d) 728, certiorari denied, 296 U. S. 657, the court held that the difference between market value and contract price of wet gas was purchaser's depletable interest and that the purchaser had failed to prove any such difference. In the instant case also the purchaser under the contract conducted the production operations and paid production expenses.

Although in the present case it is not contended that the contract gives a depletable economic interest in the oil lands to the purchaser, it may be noted that the decision of the court below gives the entire allowance to respondent, the vendor, and in effect excludes the purchaser from any possible depletion allowance, and the decision, therefore, presents a conflict in principle with the decisions of the Circuit Court of Appeals for the Ninth Circuit in the *Signal* case, *supra,* whatever may be the validity of that decision, and in *Bankline Oil Co.* v. *Com-*

missioner, 90 Fd. (2d) 899, Government's petition for certiorari granted October 25, 1937, October Term 1937, No. 387. Cf. *Thomas* v. *Perkins,* No. 824, October Term, 1936, decided June 1, 1937; *Palmer* v. *Bender,* 287 U. S. 551; *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, 320–321; *Commissioner* v. *O'Donnell,* 90 F. (2d) 907, certiorari granted October 25, 1937, October Term 1937, No. 406.

In the *Bankline* case the question is whether the purchaser of wet gas from oil producers at a contract price below market price has a depletable interest in the gas in place under a contract which did not require either the purchaser or the seller to produce wet gas from the ground.

The production expense of the purchaser was not gross income of the seller, respondent's affiliate, within the statutory (Sec. 213 of Revenue Act of 1918) or any other definition of gross income. The statement in the contract that the purchaser agreed to conduct production operations "as part of the price for oil purchased" (R. 45, 150–151) does not alter the fact that actually the purchaser under the contract agreed to bear and did bear production expenses in consideration for the seller's promise to sell all of the oil produced at a price much less than market price. The production services were promised and rendered in consideration for this valuable promise of the seller and not as part of the purchase price of the oil. This is made clear by

the fact that if no oil had been produced the services could not have been paid for in oil and, therefore, either would not be paid for at all by the seller or, as is more likely, were paid for by the seller's promise to sell all oil produced at a price less than market price. Moreover, the cost or value of the purchaser's services were not gross income of the seller because the purchaser performed the services for its own benefit.

This amount was never received by the respondent's affiliate and was never entered in its books or in the respondent's books or in the income tax return as gross income. The return included in gross income from these properties only the amount received on the sale of the oil and not these expenses (R. 48). The sum of these two amounts is not the statutory gross income intended by Congress. Cf. *Crews* v. *Commissioner*, 89 F. (2d) 412 (C. C. A. 10th); *Consumers Natural Gas Co.* v. *Commissioner*, 78 F. (2d) 161 (C. C. A. 2d), certiorari denied, 296 U. S. 634. The Government submits that by this provision of the contract whereby the purchaser paid production expenses the respondent's affiliate chose a method of production and sale of oil in which the cost of production was not part of its statutory gross income for purposes of depletion. The two methods are sufficiently different to require different tax treatment in this respect.

3. The two questions are important. The correctness of this extension of the implied constitutional immunity from Federal income taxation to income received under the agreement not with the State but with the lessee of state school lands should be determined. The contract under which the purchaser of oil pays the production expenses is common in the oil business, and the question of including those expenses in the vendor's gross income for percentage depletion may be expected to arise in a number of other cases.

CONCLUSION

Wherefore, it is respectfully submitted that this petition for certiorari should be granted.

STANLEY REED,
Solicitor General.

NOVEMBER 1937.

APPENDIX

Revenue Act of 1926, c. 27, 44 Stat. 9:

SEC. 204. * * *

(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall be depletion allowance be less than it would be if computed without reference to this paragraph.

SEC. 213. For the purposes of this title, except as otherwise provided in section 233—

(a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid,

or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period.

SEC. 234. (a) In computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:

* * * * *

(8) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commssioner with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

* * * * *

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 221. *Depletion in the case of oil and gas wells.*—Under section 204 (c) (2), in the case of oil and gas wells, a taxpayer may

deduct for depletion an amount equal to 27½ per cent of the gross income from the property during the taxable year, but such deduction shall not exceed 50 per cent of the net income of the taxpayer (computed without allowance for depletion) from the property. In no case shall the deduction computed under this paragraph be less than it would be if computed upon the basis of the cost of the property or its value at the basic date, as the case may be. In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

U. S. GOVERNMENT PRINTING OFFICE: 1937